strength
in numbers

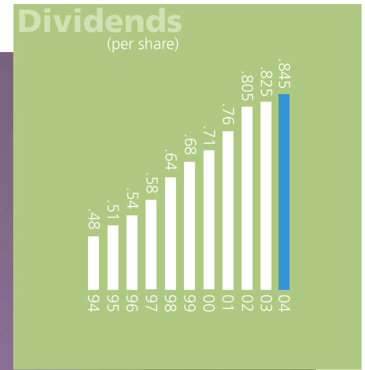
THE NATIONAL SECURITY GROUP, INC.

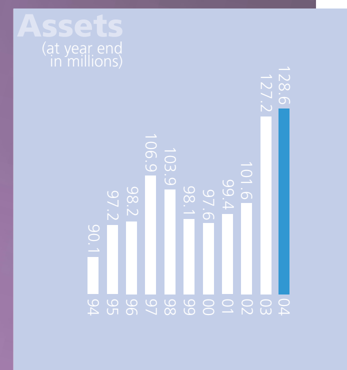
2004

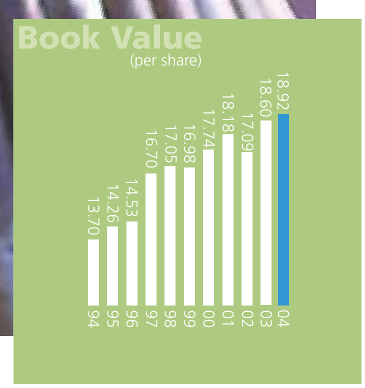
annual report

Strength

in numbers







A suspension bridge consists of hundreds of cables, each constructed of hundreds of strands of steel. The strength of the bridge is determined by the strength of each cable and each strand – and how many are used. Families depend on that strength as they use the bridge to get from one place to another. At National Security, we have spent nearly sixty years building a bridge of financial security for families to use as they get from one place in life to another. With more agents, more policyholders, more efficient processes, National Security's story is best told with numbers, and our strength is in the numbers. By carefully adding to the numbers year after year, the Company strengthens, enabling it to weather the storms each year provides. The National Security Group, Inc., is composed of three insurance companies: National Security Insurance Company (Life Company), National Security Fire and Casualty Company (Fire Company) and Omega One Insurance Company, a wholly owned subsidiary of the Fire Company. These companies provide a diversified line of insurance coverage in communities primarily in the South. Natsco, Inc., is a wholly owned subsidiary formed in 1984.

Contents

Highlights

(In thousands except per share data)

For the Year	2004	2003	Percent of Change
Earnings Per Share	1.26	1.66	(24.1)%
Earnings	3,113	4,090	(23.9)%
Net Premium Income	52,985	47,536	11.5%
Net Investment Income	4,328	4,080	6.1%
Return on Average Equity	6.7%	9.3%	
Average Shares Outstanding	2,467	2,467	
At Year End			
Shareholders' Equity Per Share	18.92	18.60	1.8%
Shareholders' Equity	46,676	45,872	1.8%
Total Assets	128,631	127,236	1.1%
Shares Outstanding	2,467	2,467	

	Stock Bid Prices High	Low	Dividends Per Share
2004			
First Quarter	26.00	19.03	.210
Second Quarter	23.60	21.51	.210
Third Quarter	25.20	20.26	.210
Fourth Quarter	22.98	21.00	.215
2003			
First Quarter	14.50	13.35	0.205
Second Quarter	14.75	11.95	0.205
Third Quarter	17.00	14.03	0.205
Fourth Quarter	20.50	15.75	0.210

1,800

insurance agents in eleven states

Plan, Prepare, Profit

The best of times and the worst of times – all in one year. In the first six months of 2004, National Security reported the best numbers in Company history. Then the storm season began. The 2004 hurricane season broke all records with six major hurricanes striking the United States, the strongest being Hurricane Ivan (shown at left). The results were sobering; over 3,000 dead and over forty-two billion dollars in U.S. damages. The last half of the year was the worst in the history of the property and casualty insurance industry. Yet, National Security sustained a profitable year. How? After a decade of deliberate planning and painstaking preparation for our growth and nature's nightmares, National Security weathered the storms in the last half of 2004 and emerged with a profit from the worst of times in industry history. From our corporate team to our agents in the field, we listen to the insurance needs of our policyholders, and we meet those needs with insurance products that are easy to understand and more accessible than ever before.

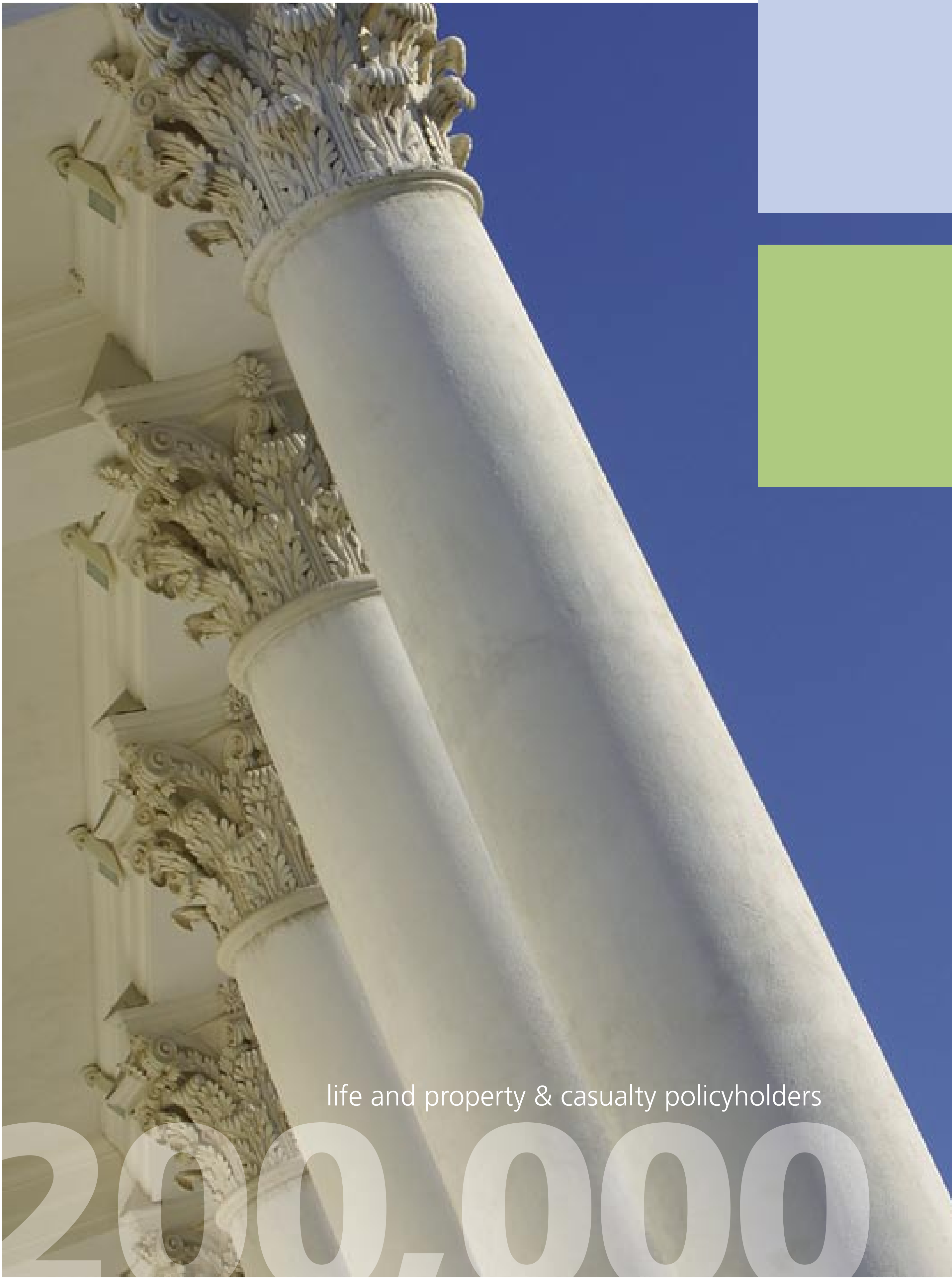
We have been increasing and equipping our agent force to bring more business in and keep it. Our corporate team has been working hard to streamline internal and external processes for maximum operating efficiency. By January of 2006, we plan to offer further enhancements to web based systems, so that our agents can spend less time processing and more time producing new business, and serving customers.

By marketing a broad array of traditional insurance products to individuals and their families through new group plans in the workplace, we help employers recruit better workers with employee benefit packages. As we add new groups to our National Security family, we multiply the number of policyholders we insure and further divide our risk.

Strength
in numbers

We are reaching communities in eleven states, teaming with more than 1800 agents to meet the insurance needs of individuals and families at home and on the job. In 2005, we are now poised to add thousands of new customers through statewide endorsements from private and public associations.

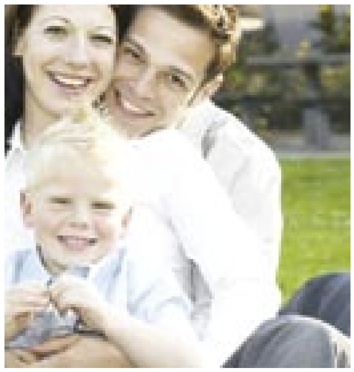
National Security is standing out in a crowd of insurance companies to provide above average service for the average American working family.


life and property & casualty policyholders
200,000

Numbers Mean a Lot to Us

The National Security Group has been tested, and we have proven ourselves to be a financial pillar of strength for families and individuals throughout the states we serve. We were hit hard, like every other insurance provider in our markets, but we still made a profit, even through the toughest times the insurance industry has ever seen.

For almost sixty years, we have weathered everything nature has thrown at us, from tornadoes to category five hurricanes. Through careful



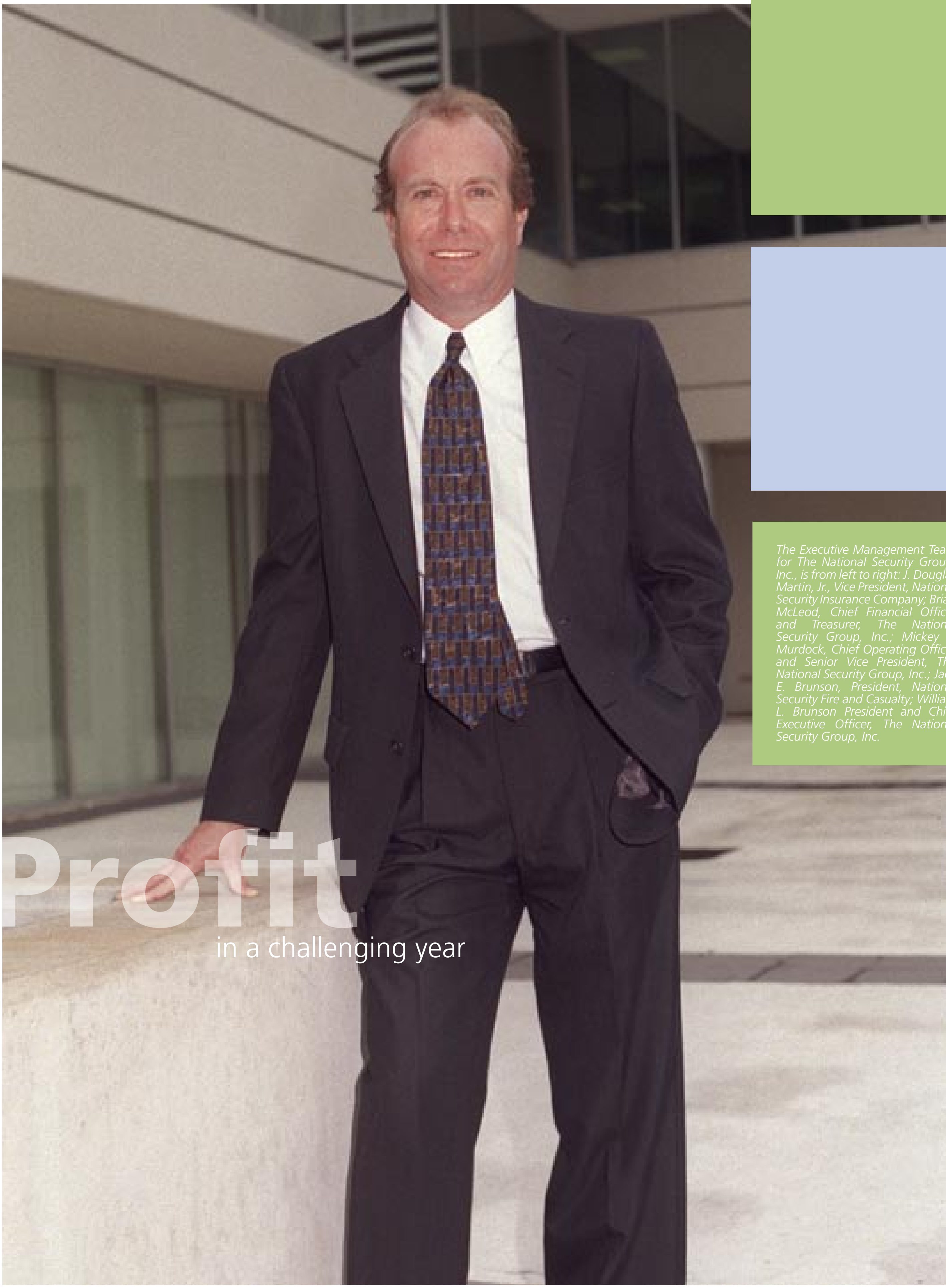
Strength
in numbers

planning, controlled growth and managing the numbers, we have learned from our mistakes and have grown healthier with each passing season. We have seen the competition come and go in the smaller communities we serve, and we continue to stand strong. We continue to recruit independent agents with experience and potential, agents who live and work in or near these communities, people who can help us meet the needs of our policyholders, their neighbors, with hometown professionalism and care.

At National Security, we measure our success and our strength by numbers, and numbers mean a lot to us. Numbers represent children who can continue their standard of living because their dad's life was insured, the mom who can continue putting food on the table because of the disability insurance she has through her workplace, the grandparents putting the pieces back together after hurricane-force winds wiped out the family homestead.

Numbers represent the callers who can still talk to an understanding and sympathetic person on the phone and receive small town service from a growing insurance company.

Take a closer look at the numbers in this report, and you will see just how strong they are – before and after nature took its course.



Profit
in a challenging year

The Executive Management Team for The National Security Group, Inc., is from left to right: J. Douglas Martin, Jr., Vice President, National Security Insurance Company; Brian McLeod, Chief Financial Officer and Treasurer, The National Security Group, Inc.; Mickey L. Murdock, Chief Operating Officer and Senior Vice President, The National Security Group, Inc.; Jack E. Brunson, President, National Security Fire and Casualty; William L. Brunson President and Chief Executive Officer, The National Security Group, Inc.

Letter to Shareholders

Assessing the Company's results for 2004 is in some respects a matter of perspective. Earnings of $3.1 million and a return on shareholders' equity of 6.7% were well below expectations. However, taking into account the fact that the Company experienced the single largest catastrophic event in its history, positive earnings and positive surplus growth becomes more significant. Hurricane Ivan, which struck the Alabama gulf coast in September, 2004 was obviously the major event of the year, greatly diminishing what could otherwise have been a very good year.

Hurricane Ivan resulted in incurred losses of over $14 million. The gross amount of losses was squarely within the projections indicated by our catastrophe reinsurance modeling. Net of catastrophe reinsurance and taxes, the losses attributable to the storm were approximately $3.6 million. Without this event, consolidated earnings would have been approximately $6.7 million or $2.71 per share, a Company record. While it's easy to lament about what could have been, we recognize that catastrophes are part of our business and, although Ivan gave us increased confidence in our reinsurance structure, it demonstrated a continuing need to diversify our business further to lessen the impact of future catastrophes on our overall performance.

Growth in premium income continued, with consolidated earned premium increasing 11.5% over 2003. Production was significantly increased in all major lines. Our premium income for 2004 is the largest in Company history and is more than double the premium income of three years ago. Shareholders' Equity was $46.7 million at year-end, or a book value per share of $18.92, a modest increase of slightly less than 2% from our equity at year-end 2003 after payment of $.845 per share in shareholder dividends. General insurance expenses were reduced from 18% in 2003 to 16% in 2004, reflecting economies of scale being attained with our growing premium base, increased employee training and technological advancements.

Considerable time was devoted in 2004 to addressing the design, operation and effectiveness of internal controls in connection with compliance with Sarbanes-Oxley legislation. Although as a non-accelerated filer, our compliance deadline has been extended to fiscal years ending after July 15, 2006, we will continue ongoing efforts in this regard. We are confident that we will be able to meet the compliance requirements.

Letter
to shareholders

In its third full year of operations, results for The Mobile Attic, Inc. were below expectations, but the potential remains significant. The Mobile Attic is a joint venture between the Company and Cash Brothers' Leasing, Inc., formed in September of 2001 as a provider of portable storage containers for industrial and household consumers. The business model was changed during 2004 from a dealer network to a franchise format, which did, unfortunately, entail a temporary interruption to ongoing operations. However, going forward this change will reduce the capital requirements of growing the business and facilitate expansion at a faster pace. There are currently twenty-one franchise locations with negotiations ongoing regarding additional locations. For 2004, Mobile Attic generated a $211,000 loss on revenues of $2.1 million. We continue to be optimistic about this venture's potential and believe it to be an excellent vehicle for further utilizing our strong capital base and providing more diversity in our business operations.

Looking ahead, we will continue to emphasize internally generated growth in our core insurance lines. To balance out the catastrophe risk inherent in property insurance focus with be placed on gaining more geographical diversity and growth in non-property product lines. Technological enhancements will be an ongoing project as will continuing to improve and develop our workforce with an emphasis on quality service and ease of doing business. With life production, emphasis will continue to be placed on further development of an independent agency network with a focus on group, association and work site product offerings.

Our results for 2004 demonstrated that while the potential is here for excellent operating results and increased shareholder value, more work (and, hopefully, cooperation from the weather) is needed to see our potential become reality. We are committed to seeing the Company realize its potential and look forward to 2005 with enthusiasm. Thank you for your continued support.

William L. Brunson, Jr.
President and CEO

Financial Review
eleven years

(Dollars in thousands-except per share figures)

Per share figures for 1994 and prior years are restated for a three-for-two stock split issued in 1994. Per share figures for 2000 and prior years are restated for a 20% stock dividend issued in 2001.

	2004	2003	2002	2001	2000	1999	1998	1997
Earnings Per Share	**1.26**	1.66	0.37	1.67	1.53	1.52	0.35	1.07
Book Value Per Share	**18.92**	18.60	17.09	18.18	17.74	16.98	17.05	16.70
Total Shareholders' Equity	**46,676**	45,872	42,159	44,884	43,780	41,888	41,968	46,352
Assets	**128,631**	127,236	101,602	99,484	97,563	98,105	103,973	106,958
Earnings	**3,113**	4,090	908	4,130	3,776	3,756	930	2,998
Investment Income	**4,328**	4,080	4,235	4,506	4,434	4,354	4,351	4,204
Return on Average Equity (Percent)	**6.7**	9.3	2.1	9.3	8.8	8.9	2.1	6.9
Premium Revenues	**52,985**	47,536	32,631	25,357	22,921	25,936	28,451	31,156
Shares Outstanding (Year-end)	**2,467**	2,467	2,467	2,467	2,056	2,056	2,051	2,313
Combined Ratio-Property & Casualty Companies								
Loss	**68.24**	60.0	75.5	54.3	61.7	70.9	87.0	79.3
Expense	**31.36**	30.8	31.9	36.1	34.8	35.8	40.3	31.0
Combined	**99.60**	90.8	107.4	90.4	96.5	106.7	127.3	110.3
Common Stock Data								
Dividends Paid Per Share	**.845**	.825	0.805	0.76	0.71	0.68	0.64	0.58
Price at Year End	**21.26**	19.26	13.5	14.49	15.63	9.17	11.56	15.10
Price Range	**26.00-19.03**	20.50-11.95	16.00-13.00	15.63-10.21	16.04-9.17	12.50-7.71	17.71-8.75	20.00-10.63
P&C Co. Premiums/Surplus Ratio	**1.5**	1.5	1.2	0.7	0.6	0.8	0.9	0.9
Life Co. Insurance in Force (Millions)	**178**	179	176	176	151	141	132	132
BEST's Rating								
P&C Company	**B++**	B++	B++	B++	B++	B++	B++	A-
Life Company	**B**	B	B	B	B	B	B	B
Debt (Thousands)	**15,836**	10,921	3,380	2,108	2,401	2,672	3,004	133

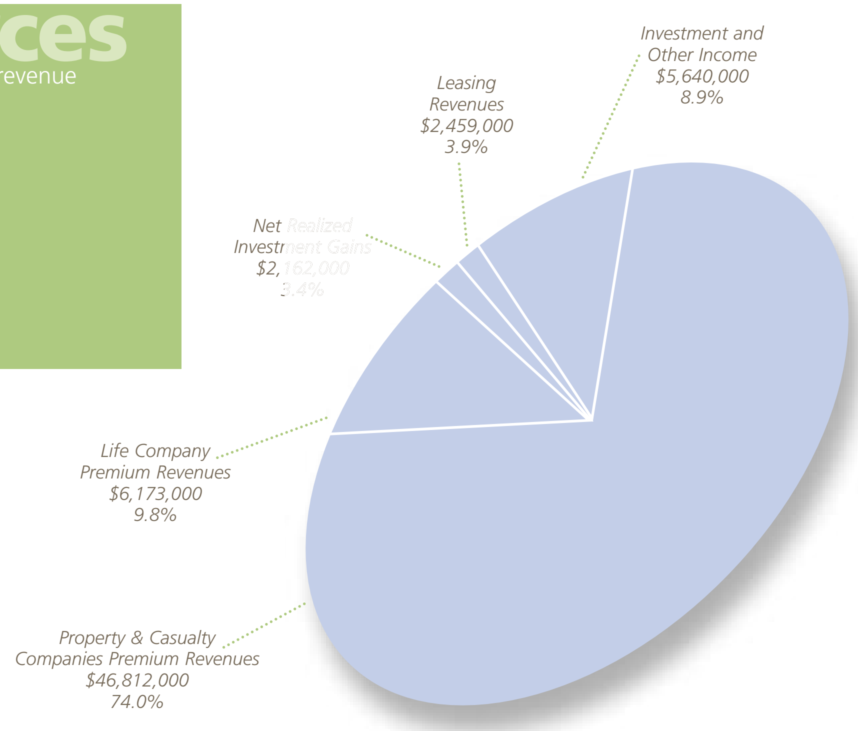
1996	1995	1994
0.48	0.08	1.31
14.53	14.26	13.70
40,519	39,774	38,482
98,219	97,266	90,116
1,356	214	3,674
3,935	4,311	4,001
3.4	0.5	9.5
26,654	24,372	26,289
2,320	2,325	2,340
79.8	82.7	64.2
30.9	29.4	28.0
110.7	112.1	92.2
0.54	0.51	0.48
10.94	10.73	13.75
11.88-9.69	15.00-10.21	15.13-13.47
0.8	0.7	0.9
138	142	149
A-	A	A
B	B	B
182	224	0

2004 Financial Results on a Quarterly Basis

(In thousands except per share figures)

	Premium Revenues	Leasing Revenues	Investment & Other Income	Realized Investment Gains or (losses)	Benefits	Net Income	Net Income Per Share
2004							
1st QTR	$13,795	$ 374	$1,396	$ 387	$ 7,912	$1,053	$0.43
2nd QTR	14,105	529	1,520	699	7,697	2,444	0.99
3rd QTR	11,972	989	1,391	569	11,924	(1,622)	(0.66)
4th QTR	13,113	567	1,333	507	7,534	1,238	0.50
Total	$52,985	$2,459	$5,640	$2,162	$35,067	$3,113	$1.26
2003							
1st QTR	$ 9,927	$ 258	$1,392	$ 66	$ 6,052	$ 770	$0.31
2nd QTR	12,025	307	1,516	595	7,531	1,326	0.54
3rd QTR	12,397	465	1,388	54	6,960	912	0.37
4th QTR	13,187	403	1,179	701	7,002	1,082	0.44
Total	$47,536	$1,433	$5,475	$1,416	$27,545	$4,090	$1.66

Sources of revenue



Consolidated Statements of Income

The National Security Group, Inc.

Dollars In thousands except per share amounts	Year ended December 31,		
	2004	2003	2002
Revenues			
Net premiums earned	**$ 52,985**	$ 47.536	$ 32,631
Net investment income	**4,328**	4,080	4,235
Net realized investment gains	**2,162**	1,416	1,168
Net revenues from leasing operations	**2,459**	1,433	942
Other income	**1,312**	1,395	1,051
	63,246	55,860	40,027
Benefits and Expenses			
Policyholder benefits paid or provided	**35,067**	27,545	22,763
Amortization of deferred policy acquisition costs	**2,221**	1,825	1,406
Commissions	**8,646**	8,901	6,222
General insurance expenses	**8,608**	8,566	5,943
Expenses from leasing operations	**2,106**	1,045	502
Insurance taxes, licenses and fees	**2,018**	1,718	1,311
Interest expense	**727**	632	410
	59,393	50,232	38,557
Income Before Income Taxes and Minority Interest	**3,853**	5,628	1,470
Income Tax Expense (Benefit)			
Current	**482**	1,703	394
Deferred	**364**	(138)	106
	846	1,565	500
Income Before Minority Interest	**3,007**	4,063	970
Loss (Income) of Minority Interest	**106**	27	(62)
Net Income	**$ 3,113**	$ 4,090	$ 908
Earnings per Common Share			
Net Income	**$ 1.26**	$ 1.66	$ 0.37

See accompanying notes to consolidated financial statements.

Dollars In thousands

	December 31, 2004	December 31, 2003
Assets		
Investments		
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2004 - $19,967; 2003 - $18,198)	**$ 20,280**	$ 18,631
Fixed maturities available-for-sale, at estimated fair value (cost: 2004 - $50,164; 2003 - $53,000)	**50,889**	54,715
Equity securities available-for-sale at estimated fair value (cost: 2004 - $8,995; 2003 - $10,205)	**20,173**	20,732
Mortgage loans on real estate, at cost	**238**	245
Investment real estate, at book value (accumulated depreciation: 2004 - $17; 2003 - $17)	**1,463**	1,564
Policy loans	**771**	730
Other invested assets	**2,973**	-
Short-term investments	**250**	300
Total Investments	**97,037**	96,917
Cash	**360**	1,295
Accrued investment income	**744**	930
Receivable from agents, less allowance for credit losses (2004 - $110; 2003 - $140)	**2,465**	2,602
Reinsurance recoverable	**3,318**	1,799
Deferred policy acquisition costs	**6,217**	5,817
Property and equipment, net	**16,907**	16,513
Other assets	**1,583**	1,363
Total Assets	**$128,631**	$127,236
Liabilities and Shareholders' Equity		
Note payable	**$ –**	$ 5,000
Policy and claim reserves	**52,707**	49,311
Other policyholder funds	**1,311**	1,416
Long-term debt	**15,836**	10,921
Accrued income taxes	**-**	1,486
Other liabilities	**7,876**	9,122
Deferred income tax	**3,473**	3,223
Total Liabilities	**81,203**	80,479
Contingencies	**–**	–
Minority interest	**752**	885
Shareholders' equity		
Preferred stock, $1 par value, 500,000 shares authorized, none issued or outstanding	**–**	–
Class A common stock, $1 par value, 2,000,000 shares authorized, none issued or outstanding.	**–**	–
Common stock, $1 par value, 10,000,000 and 2,500,000 shares authorized, respectively 2,466,600 shares issued and outstanding	**2,467**	2,467
Additional paid-in capital	**4,951**	4,951
Accumulated other comprehensive income	**8,404**	8,629
Retained earnings	**30,854**	29,825
Total Shareholders' Equity	**46,676**	45,872
Total Liabilities and Shareholders' Equity	**$128,631**	$127,236

See accompanying notes to consolidated financial statements.

Dollars in thousands

	Total	Comprehensive Income (Loss)	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock	Paid-in Capital
Balance at December 31, 2001	$ 44,884		$ 28,848	$ 8,618	$ 2,467	$ 4,951
Comprehensive loss:						
Net income for 2002	908	908	908	–	–	–
Other comprehensive loss, net of tax						
Unrealized loss on securities, net of reclassification adjustment of $852	(1,647)	(1,647)	–	(1,647)	–	–
Comprehensive loss		(739)				
Cash dividends	(1,986)		(1,986)	–	–	–
Balance at December 31, 2002	42,159		27,770	6,971	2,467	4,951
Comprehensive Income:						
Net income for 2003	4,090	4,090	4,090	–	–	–
Other comprehensive income, net of tax						
Unrealized loss on securities, net of reclassification adjustment of $1,130	1,658	1,658	–	1,658	–	–
Comprehensive Income		5,748				
Cash dividends	(2,035)		(2,035)	–	–	–
Balance at December 31, 2003	45,872		29,825	8,629	2,467	4,951
Comprehensive income:						
Net income for 2004	3,113	3,113	3,113	–	–	–
Other comprehensive loss, net of tax						
Unrealized loss on securities, net of reclassification adjustment of $1,483	(225)	(225)	–	(225)	–	–
Comprehensive income		2,888				
Cash dividends	(2,084)		(2,084)	–	–	–
Balance at December 31, 2004	$ 46,676		$ 30,854	$ 8,404	$ 2,467	$ 4,951

See accompanying notes to consolidated financial statements.

Dollars In thousands	Year ended December 31,		
	2004	2003	2002
Cash flows from operating activities:			
Net income	**$ 3,113**	$ 4,090	$ 908
Adjustments to reconcile net income to net cash provided by operating activities:			
Change in accrued investment income	**186**	80	(72)
Change in reinsurance recoverable	**(1,519)**	(100)	1,825
Amortization of deferred policy acquisition costs	**2,221**	1,825	1,406
Change in receivable for securities	**–**	–	50
Net realized gains on investments	**(2,162)**	(1,416)	(1,163)
Policy acquisition costs deferred	**(2,621)**	(2,399)	(2,034)
Change in prepaid reinsurance premiums	**29**	(153)	(52)
Depreciation expense and amortization/accretion	**700**	808	278
Change in policy liabilities and claims	**3,396**	4,257	3,315
Change in income tax payable	**(1,486)**	1,253	(379)
Change in deferred income taxes	**362**	(260)	376
Change in other liabilities	**(1,246)**	3,991	1,250
Loss of Minority Interest	**106**	29	136
Other, net	**(193)**	(607)	(655)
Net cash provided by operating activities	**886**	11,398	5,189
Cash flows from investing activities:			
Purchases of held-to-maturity securities	**(19,379)**	(17,694)	(1,777)
Purchases of available-for-sale securities	**(4,933)**	(22,455)	(19,600)
Proceeds from maturities of held-to-maturity securities	**3,176**	13,271	5,564
Proceeds from sales of available-for-sale securities	**25,687**	17,379	14,141
Proceeds from sale of real estate held for investment	**124**	24	95
Purchases of real estate held for investment	**–**	–	(53)
Purchase of other invested assets	**(3,358)**	–	–
Proceeds from sales of other invested assets	**385**	–	–
Net proceeds from sale (purchases) of short-term investments	**50**	1,152	(1,202)
(Advances on) repayment of loans, net	**(41)**	641	(1,090)
Purchase of property and equipment	**(1,327)**	(8,078)	(2,911)
Proceeds from sale of property and equipment	**69**	5	–
Net cash provided by (used in) investing activities	**453**	(15,755)	(6,833)
Cash flows from financing activities:			
Proceeds from debt	**243**	7,862	2,734
Payments on debt	**(328)**	(946)	–
Change in other policyholder funds	**(105)**	(111)	24
Dividends paid	**(2,084)**	(2,035)	(1,986)
Net cash (used in) provided by financing activities	**(2,274)**	4,770	772
Net (decrease) increase in cash	**(935)**	413	(872)
Cash at beginning of year	**1,295**	882	1,754
Cash at end of year	**$ 360**	$ 1,295	$ 882

See accompanying notes to consolidated financial statements.

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

(a) Principles of Consolidation

The accompanying consolidated financial statements include the accounts of The National Security Group, Inc. (the Company) and its wholly-owned subsidiaries: National Security Insurance Company (NSIC), National Security Fire and Casualty Company (NSFC) and NATSCO, Inc. (NATSCO). NSFC includes a wholly-owned subsidiary - Omega One Insurance Company (Omega). All significant intercompany transactions and accounts have been eliminated.

The accompanying consolidated financial statements also include an investment in affiliate, which consists of a fifty percent interest in The Mobile Attic, Inc and its wholly owned subsidiary established in January of 2004, Mobile Attic Franchising Company (MAFCO). The Mobile Attic, Inc. is a portable storage leasing company that began operations in 2001. MAFCO was established in the first quarter of 2004 to conduct the business of selling Mobile Attic portable storage leasing franchises. Effective in the first quarter of 2004 the Company consolidated the accounts of Mobile Attic, Inc. and subsidiary MAFCO according to guidance in Financial Accounting Standards Board Interpretation 46 as revised December 2003 (FIN 46R).

Changes in financial statement presentation as a result of the adoption of recently issued accounting standards:

As disclosed in the notes to the audited consolidated financial statements for the year ended December 31, 2003, the Company adopted Financial Accounting Standards Board Interpretation 46 as revised December 2003 (FIN 46R), in the first quarter of 2004. As a result of the adoption of FIN 46R, triggered by previously existing and disclosed guarantees of Mobile Attic debt by the Company, the Company consolidated an investment in a subsidiary Mobile Attic, Inc. Further details of the debt guarantees are discussed in Note 2 to these consolidated financial statements.

Mobile Attic was previously reported using the equity method of accounting. For comparative purposes, the Company made adjustments to the December 31, 2003 Balance Sheet shown in these audited financial statements and the Income Statement and Statement of Cash Flows for the periods ended December 31, 2003 and 2002. These adjustments increased December 31, 2003 assets by $15,109,000 and liabilities by $13,394,000. The adjustment had no effect on consolidated stockholders' equity. Certain accounts in the Income Statement for the periods ended December 31, 2003 and 2002 were adjusted as a result of the consolidation of Mobile Attic, but because the results of Mobile Attic were previously reported under the equity method, the adjustments had no effect on the consolidated results of operations for the periods ended December 31, 2003 and 2002. Cash flow, for the years ended December 31, 2003 and 2002, from operating activities increased $79,000 and $327,000, respectively; from investing activities decreased $7,224,000 and $1,872,000, respectively; and from financing activities increased $7,862,000 and $362,000, respectively. Total cash increased $169,000 and $77,000, respectively.

(b) Description of Major Products

NSIC is licensed in the states of Alabama, Florida, Georgia, Mississippi, South Carolina and Texas and was organized in 1947 to provide life and burial insurance policies to the home service market. Business is now produced by both company and independent agents. Primary products include ordinary life, accident and health, supplemental hospital, and cancer insurance products.

NSFC is licensed in Alabama, Arkansas, Florida, Georgia, Mississippi, Oklahoma, South Carolina, and Tennessee. In addition NSFC operates on a surplus lines basis in Louisiana, Missouri, and Texas. NSFC operates in various property and casualty lines, the most significant of which are dwelling property fire and extended coverage, homeowners, mobile homeowners, ocean marine, nonstandard automobile physical damage and liability and nonstandard commercial auto liability.

Omega is licensed in the states of Alabama and Louisiana. Omega operates in property and casualty lines, the most significant of which are homeowners and nonstandard automobile physical damage and liability.

(c) Basis of Presentation

The significant accounting policies followed by the Company and subsidiaries that materially affect financial reporting are summarized below. The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles (GAAP) which, as to the subsidiary insurance companies, differ from statutory accounting practices permitted by regulatory authorities.

(d) Investments

The Company's securities are classified in two categories and accounted for as follows:

- *Securities Held-to-Maturity.* Bonds, notes and redeemable preferred stock for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts which are recognized in interest income using methods which approximate level yields over the period to maturity.
- *Securities Available-for-Sale.* Bonds, notes, common stock and non-redeemable preferred stock not classified as either held-to-maturity, or trading are reported at fair value, adjusted for other-than-temporary declines in fair value. The Company and its subsidiaries have no trading securities.

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES CONTINUED

Unrealized holding gains and losses, net of tax, on securities available-for-sale are reported as a net amount in a separate component of shareholders' equity until realized.

Realized gains and losses on the sale of securities available-for-sale are determined using the specific-identification method.

Mortgage loans and policy loans are stated at the unpaid principal balance of such loans. Investment real estate is reported at cost, less allowances for depreciation computed on the straight-line basis. Short-term investments are carried at cost, which approximates market value. Investments with other than temporary impairment in value are written down to estimated realizable values.

Other invested assets consist principally of state sponsored investments with a portion of the investment yield derived from insurance premium tax credits. These investments are reported at the unpaid principal balance.

(e) Receivable from Agents

Agent balances are reported at unpaid balances, less a provision for credit losses.

(f) Property and Equipment

Property and equipment is carried at cost less accumulated depreciation and includes expenditures that substantially increase the useful lives of existing property and equipment. Maintenance, repairs, and minor renovations are charged to expense as incurred. Upon sale or retirement of property and equipment, the cost and related accumulated depreciation are eliminated from the respective account and the resulting gain or loss is included in the results of operations. The Company provides for depreciation of property and equipment using the straight-line method designed to amortize costs over estimated useful lives. Estimated useful lives range up to 40 years for buildings and from 3-20 years for electronic data processing equipment and furniture and fixtures.

(g) Fair Value of Financial Instruments

The table below presents the carrying value and fair value of the Company's financial instruments, as defined in accordance with applicable requirements. Fair values of the Company's financial instruments are estimated by reference to quoted prices from market sources and financial institutions, as well as other valuation techniques. In cases where quoted market prices are not available, fair values are estimated using present value or other valuation techniques. The fair value estimates are made at a specific point in time, based on available market information and judgments about the financial instrument, such as estimates of timing and amount of expected future cash flows. Such estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument, nor do they consider the tax impact of the realization of unrealized gains or losses. In many cases, the fair value estimates cannot be substantiated by comparison to independent markets, nor can the disclosed value be realized in immediate settlement of the instrument.

Certain financial instruments, particularly insurance liabilities other than financial guarantees and investment contracts are excluded from the disclosures. In evaluating the Company's management of interest rate and liquidity risk, the fair values of all assets and liabilities should be taken into consideration.

The fair values of cash, cash equivalents, short-term investments and balances due on accounts from agents, reinsurers and others approximate their carrying amounts as reflected in the consolidated balance sheet due to their short-term availability or maturity.

Dollars in thousands	December 31, 2004		2003	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets and related Instruments				
Debt and equity securities	$ 91,342	$ 91,029	$ 94,078	$ 93,645
Mortgage loans	238	238	245	245
Policy loans	771	771	730	730
Liabilities and related Instruments				
Other policyholder funds	1,311	1,311	1,416	1,416
Long-term debt	15,836	15,836	10,921	10,921

(h) Statement of Cash Flows

For purposes of reporting cash flows, cash includes cash-on-hand, demand deposits with banks and overnight investments.

(i) Premium Revenues

Life insurance premiums are recognized as revenues when due. Property and casualty insurance premiums, less amounts ceded to reinsurers, are recognized on a pro rata basis over the terms of the policies. Reinsurance premiums assumed are recognized as reported by the ceding company.

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES CONTINUED

(j) Deferred Policy Acquisition Costs

The costs of acquiring new insurance business are deferred and amortized over the lives of the policies. Deferred costs include commissions, other agency compensation and expenses, and other underwriting expenses directly related to the level of new business produced.

Acquisition costs relating to life contracts are amortized over the premium paying period of the contracts, or the first renewal period of term policies, if earlier. Assumptions utilized in amortization are consistent with those utilized in computing policy liabilities.

The method of computing the deferred policy acquisition costs for property and casualty policies limits the amount deferred to a percentage of related unearned premiums.

(k) Policy Liabilities

The liability for future life insurance policy benefits is computed using a net level premium method including the following assumptions:

Years of Issue	Interest rate
1947 - 1968	4%
1969 - 1978	6% graded to 5%
1979 - 2004	7% graded to 6%

Mortality assumptions include various percentages of the 1955-60 and 1965-70 Select and Ultimate Basic Male Mortality Table. Withdrawal assumptions are based on the Company's experience.

(l) Claim Liabilities

The liability for unpaid claims represents the estimated liability for claims reported to the Company and its subsidiaries plus claims incurred but not yet reported and the related adjustment expenses. The liabilities for claims and related adjustment expenses are determined using case-basis evaluations and statistical analyses and represent estimates of the ultimate net cost of all losses incurred through December 31 of each year. Although considerable variability is inherent in such estimates, management believes that the liabilities for unpaid claims and related adjustment expenses are adequate. The estimates are continually reviewed and adjusted as necessary; such adjustments are included in current operations.

(m) Earnings Per Share

Earnings per share of common stock is based on the weighted average number of shares outstanding during each year. The adjusted weighted average shares outstanding were 2,466,600 (2,466,600 in 2003 and 2002).

(n) Reinsurance

In the normal course of business, NSFC seeks to reduce the loss that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers. Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policy. Amounts paid for prospective reinsurance contracts are reported as prepaid reinsurance premiums and amortized over the remaining contract period.

In the normal course of business, NSIC seeks to limit its exposure to loss on any single insured and to recover a portion of benefits paid by ceding reinsurance to other insurance enterprises or reinsurers under excess coverage contracts. NSIC retains a maximum of $30,000 of coverage per individual life. The cost of reinsurance is amortized over the contract period of the reinsurance.

(o) Reclassifications

Certain reclassifications have been made in the previously reported financial statements to make the prior year amounts comparable to those of the current year. Such reclassifications had no effect on the previously reported net income or shareholders' equity.

(p) Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(q) Advertising

The Company expenses advertising costs as incurred. Advertising costs were $142,000 for the year ended December 31, 2004 ($118,000 and $114,000 for the years ended December 31, 2003 and 2002, respectively).

(r) Concentration of Credit Risk

The Company maintains cash depository accounts which, at times, may exceed federally insured limits. These amounts represent actual account balances held by financial institutions at the end of the period, and unlike the balance reported in the financial statements, the account balances do not reflect timing delays inherent in reconciling items such as outstanding checks and deposits in transit. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant credit risk on cash and cash equivalents. At December 31, 2004, the Company's uninsured cash balances totaled $313,000.

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES CONTINUED

(s)Recently Issued Accounting Standards

In December 2004, the Financial Accounting Standards Board (FASB) issued two pronouncements and a revision of Statement of Financial Accounting Standards (SFAS) No. 123:

SFAS No. 153, *Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29,* Eliminates the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. The adoption of this statement is not expected to have a material impact on the Company's financial position or results of operations.

SFAS No. 152, *Accounting for Real Estate Time-Sharing Transactions-an amendment of SFAS No. 66 and 67,* amends SFAS No. 66 to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 04-02. This statement also amends SFAS No. 67 to state that the guidance for incidental operations and costs incurred to sell real estate projects does not apply to real estate time-sharing transactions. The accounting for those operations and costs is subject to the guidance of SOP 04-2. The adoption of this statement is not expected to have a material impact on the Company's financial position or results of operations.

SFAS No. 123 *revised, Share-Based Payment*, establishes standards for the accounting of transactions in which an entity exchanges its equity instruments for goods or services. The adoption of this statement is not expected to have a material impact on the Company's financial position or results of operations.

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs—an amendment of Accounting Research Bulletin (ARB) No. 43, Chapter 4,* which clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material. The adoption of this statement is not expected to have a material impact on the Company's financial position or results of operations.

NOTE 2 – VARIABLE INTEREST ENTITY

In December 2003, the FASB issued Revised FIN 46 (FIN 46R) to clarify certain aspects of FIN 46 including the determination of who is the primary beneficiary of a variable interest entity (VIE). FIN 46R postponed the effective date as to when companies are required to apply the provisions prospectively for all variable interest entities in existence prior to January 31, 2003 until the first financial reporting period that ends after March 15, 2004. However, for entities that are considered to be special purpose entities, the effective date of FIN 46R is financial reporting periods after December 15, 2003. The Company does not have an interest in any special purpose entities. The Company consolidated its affiliate, Mobile Attic, Inc., upon adoption of FIN 46R in the first quarter 2004 due to the Company's guarantee of Mobile Attic's line of credit. The consolidation of Mobile Attic increased total assets by approximately $15 million and total liabilities by approximately $13 million. There was no effect on total shareholders' equity. The consolidation of Mobile Attic did not have a material impact on the results of operations as the Company previously accounted for the investment under the equity method. See Note 17 for additional information related to the VIE.

NOTE 3 - STATUTORY ACCOUNTING PRACTICES

The accompanying consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) which vary in certain respects from reporting practices prescribed or permitted by insurance regulatory authorities. The significant differences for statutory reporting include: (a) acquisition costs of acquiring new business are charged to operations as incurred, (b) life policy liabilities are established utilizing interest and mortality factors specified by regulatory authorities, (c) the Asset Valuation Reserve (AVR) and the Interest Maintenance Reserve (IMR) are recorded as liabilities, and (d) non-admitted assets (furniture and equipment, agents' debit balances and prepaid expenses) are charged directly to surplus.

Statutory net gains from operations and capital and surplus, excluding intercompany transactions, are summarized as follows:

Dollars in thousands	Year ended December 31, 2004	2003	2002
NSIC - including realized capital (losses) gains of $(56), $287 and $356, respectively . $	291	$ 7	$ 729
NSFC - including realized capital gains of $1,847, $203 and $622, respectively .... $	2,164	$ 2,526	$(789)
OMEGA - including realized capital gains of $35, $257, and $150, respectively .... $	667	$ 779	$ 702
Statutory Capital and Surplus: NSIC - including AVR of $1,153, $1,180, and $580, respectively	$10,298	$10,195	$10,895
NSFC	$23,766	$23,104	$20,201
OMEGA	$ 7,594	$ 6,691	$ 5,656

NOTE 3 - STATUTORY ACCOUNTING PRACTICES CONTINUED

The above amounts exclude allocation of overhead from the Company. NSIC, NSFC and Omega are in compliance with statutory restrictions with regard to minimum amounts of surplus and capital.

NOTE 4 - INVESTMENT SECURITIES

The amortized cost and aggregate fair values of investments in securities are as follows:

Dollars in thousands	December 31, 2004			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
Corporate debt securities	$10,379	$ 473	$ 23	$10,829
Obligations of states and political subdivisions	9,609	446	93	9,962
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	30,176	155	233	30,098
Total fixed maturities	50,164	1,074	349	50,889
Equity securities	8,995	11,590	412	20,173
Total	$59,159	$12,664	$ 761	$71,062
Held-to-maturity securities:				
Obligations of states and political subdivisions	$ 2,279	$ 18	$ 33	$ 2,264
U.S. Treasury securities and obligations of U.S. government corporations and agencies	18,001	53	351	17,703
Total	$20,280	$ 71	$ 384	$19,967

Dollars in thousands	December 31, 2003			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
Corporate debt securities	$18,036	$ 1,331	$ 27	$19,340
Obligations of states and political subdivisions	10,198	506	181	10,523
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	24,766	292	206	24,852
Total fixed maturities	53,000	2,129	414	54,715
Equity securities	10,205	11,011	484	20,732
Total	$63,205	$13,140	$ 898	$75,447
Held-to-maturity securities:				
Obligations of states and political subdivisions	$ 4,635	$ 37	$ 136	$ 4,536
U.S. Treasury securities and obligations of U.S. government corporations and agencies	13,996	48	382	13,662
Total	$18,631	$ 85	$ 518	$18,198

The amortized cost and aggregate fair value of debt securities at December 31, 2004, by contractual maturity, are as follows. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Dollars in thousands	Amortized Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	$ 709	$ 719
Due after one year through five years	18,392	19,353
Due after five years through ten years	13,419	13,104
Due after ten years	17,644	17,713
Total	$ 50,164	$ 50,889
Held-to-maturity securities:		
Due in one year or less	$ –	$ –
Due after one year through five years	8,375	8,306
Due after five years through ten years	5,215	5,102
Due after ten years	6,690	6,559
Total	$ 20,280	$ 19,967

NOTE 4 - INVESTMENT SECURITIES CONTINUED

For 2004, gross gains of $2,218,867 ($2,266,000 for 2003 and $1,412,000 for 2002) and gross losses of $129,880 ($858,000 for 2003 and $318,000 for 2002) were realized on sales of available-for-sale-securities.

During the first quarter of 2003, the Company transferred certain corporate bonds from SFAS No. 115 classification of held-to-maturity to available-for-sale. This decision was made due to circumstances considered by the Company to be both unusual and nonrecurring, which could not have been reasonably anticipated. With interest rates at four decade lows and corporate bond spreads extremely tight relative to U.S. Treasury securities, the Company intends to sell certain (primarily corporate) bonds which were previously held in the SFAS 115 classification of held-to-maturity. The proceeds of these bonds will be reinvested primarily in agency securities and in the process raise the overall credit quality of the portfolio. The net carrying amount of the securities transferred was $9,833,000 and unrealized gains (net of tax) on these securities totaled $467,000 at the transfer date.

The gross realized investment losses and related fair value for securities available for sale at December 31, 2004 were as follows:

Dollars in thousands	Less than 12 months		12 months or longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Fixed maturities						
Corporate	$ 542	$ 11	$ 542	$ 11	$ 1,084	$ 22
Obligations of state and political subdivisions	1,457	20	3,489	74	4,946	94
U.S. Treasury securities and obligations of U.S. Goverment corporations and agencies	6,561	78	9,533	154	16,094	232
Equity securities	576	23	774	390	1,350	413
	$9,136	$ 132	$14,338	$ 629	$23,474	$ 761

All unrealized losses are reviewed to determine whether the losses are other than temporary. Factors considered include whether the securities are backed by the U.S. Government or its agencies and concerns surrounding the recovery of full principal. Management believes the unrealized losses are market driven and no ultimate loss will occur.

NOTE 5 - NET INVESTMENT INCOME

Major categories of investment income are summarized as follows:

Dollars in thousands	Year ended December 31,		
	2004	2003	2002
Fixed maturities	$ 3,704	$ 3,618	$ 3,722
Equity securities	503	528	539
Mortgage loans on real estate	18	19	25
Investment real estate	15	103	24
Policy loans	2	32	37
Other, principally short-term investments	321	41	108
	4,563	4,341	4,455
Less: Investment expenses	235	261	220
Net investment income	$ 4,328	$ 4,080	$ 4,235

An analysis of investment gains follows:

Dollars in thousands	Year ended December 31,		
	2004	2003	2002
Net realized investment gains (losses):			
Fixed maturities	$ 431	$ 627	$(6)
Other, principally equity securities	1,731	789	1,174
	$ 2,162	$ 1,416	$ 1,168

An analysis of the net increase (decrease) in unrealized appreciation on available-for-sale securities follows:

Dollars in thousands	Year ended December 31,		
	2004	2003	2002
Net (decrease) increase in unrealized appreciation on available-for-sale securities before deferred income tax	$(339)	$ 2,520	$(2,495)
Deferred income tax	114	(862)	848
Net (decrease) in unrealized appreciation on available-for-sale securities	$(225)	$ 1,658	$(1,647)

NOTE 6 - PROPERTY AND EQUIPMENT

At December 31, property and equipment consisted of the following:

Dollars in thousands	2004	2003
Building and improvements	$ 1,876	$ 1,660
Electronic data processing equipment	1,936	2,223
Leasing equipment	15,077	14,593
Furniture and fixtures	1,076	880
	19,965	19,356
Less accumulated depreciation	3,058	2,843
	$ 16,907	$ 16,513

Depreciation expense for the year ended December 31, 2004 was $805,000 ($686,000 for the year ended December 31, 2003 and $289,000 for the year ended December 31, 2002).

NOTE 7 - INCOME TAXES

Total income tax expense varies from amounts computed by applying current federal income tax rates to income before income taxes. The reason for these differences and the approximate tax effects are as follows:

Dollars in thousands	Year ended December 31,		
	2004	2003	2002
Federal income tax rate applied to pre-tax income	$ 1,310	$ 1,927	$ 500
Dividends received deduction and tax-exempt interest	(196)	(176)	(184)
Small life insurance company deduction	–	(18)	(230)
Other, net	(268)	(168)	414
Federal income tax expense	$ 846	$ 1,565	$ 500

Net deferred tax liabilities are determined based on the estimated future tax effects of differences between the financial statement and tax basis of assets and liabilities given the provisions of the enacted tax laws.

The tax effect of significant differences representing deferred assets and liabilities are as follows:

Dollars in thousands	December 31,	
	2004	2003
General insurance expenses	$ 1,178	$ 1,107
Unearned premiums	973	908
Claim liabilities	299	279
Policy liabilities	140	209
Deferred tax assets	2,590	2,503
Depreciation	(448)	(135)
Deferred policy acquisition costs	(2,116)	(1,978)
Unrealized gains on securities available-for-sale	(3,499)	(3,613)
Deferred tax liabilities	(6,063)	(5,726)
Net deferred tax liability	$(3,473)	$(3,223)

The appropriate income tax effects of changes in temporary differences are as follows:

Dollars in thousands	Year ended December 31,		
	2004	2003	2002
Deferred policy acquisition costs	$ 138	$ 196	$ 213
Policy liabilities	69	70	70
Unearned premiums	(65)	(263)	(181)
General insurance expenses	(71)	(306)	(42)
Alternative minimum tax credit carryforwards	–	–	45
Depreciation	313	135	–
Claim liabilities	(20)	30	1
	$ 364	$(138)	$ 106

Under pre-1984 life insurance company tax laws, a portion of NSIC's gain from operations was not subject to current income taxation, but was accumulated for tax purposes in a memorandum account designated "policyholders' surplus". The aggregate balance in this account, $3,720,000 at December 31, 2004, would be taxed at current rates only if distributed to shareholders or if the account exceeded a prescribed minimum. The Deficit Reduction Act of 1984 eliminated additions to policyholders' surplus for 1984 and thereafter. Deferred taxes have not been provided on amounts designated as policyholders' surplus. The deferred income tax liability not recognized is approximately $1,270,000 at December 31, 2004.

NOTE 8 - NOTES PAYABLE AND LONG-TERM DEBT

Long-term debt consisted of the following as of December 31:

Dollars in thousands	2004	2003
Note payable to bank with an interest rate based on prime plus 50 basis points which was at 4.5% at December 31, 2003; matured April 2004	$ –	$ 5,000
Note payable to bank with an interest rate based on LIBOR (5.15% at December 31, 2004 and 3.87% at December 31, 2003) dated March, 2002; maturity March, 2007. Payments of $113 due quarterly with balloon payment at maturity. Unsecured	$ 2,731	$ 3,059
Note payable to bank with an interest rate based on prime minus 25 basis points (5.00% at December 31, 2004) dated June, 2004; maturity June, 2007. Interest payments due quarterly. Secured by $14,462 of leasing equipment	$ 13,105	$ 7,862
	$ 15,836	$ 10,921

Aggregate maturities of long-term debt for each of the three years subsequent to December 31, 2004 are as follows (dollars in thousands): 2005-$351; 2006-$365; 2007-$15,120.

NOTE 9 - POLICY AND CLAIM RESERVES

At December 31, policy and claim reserves consisted of the following:

Dollars in thousands	2004	2003
Benefit and loss reserves		
Property and casualty	$ 13,094	$ 11,343
Accident and Health	480	411
Life and Annuity	23,935	23,331
Unearned premiums	14,779	13,750
Policy and contract claims	419	476
	$ 52,707	$ 49,311

The following table is a reconciliation of beginning and ending property and casualty reserve balances for claims and claim adjustment expense for the years ended December 31:

Dollars in thousands	2004	2003	2002
Claims and claim adjustment expense reserves at beginning of year	$ 11,343	$ 11,513	$ 11,489
Less reinsurance recoverables on unpaid losses	1,232	1,555	2,396
Net balances at beginning of year	10,111	9,958	9,093
Provisions for claims and claim adjustment expenses for claims arising in current year	32,702	27,066	22,111
Estimated claims and claim adjustment expenses for claims arising in prior years	(1,091)	(1,928)	(1,547)
Total increases	31,611	25,138	20,564
Claims and claim adjustment expense payments for claims arising in:			
Current year	25,837	19,892	15,594
Prior years	5,402	5,093	4,105
Total payments	31,239	24,985	19,699
Net balance at end of year	10,483	10,111	9,958
Plus reinsurance recoverables on unpaid losses	2,611	1,232	1,555
Claims and claim adjustment expense reserves at end of year	$ 13,094	$ 11,343	$ 11,513

The provision for claims and claim adjustment expenses for prior years (net of reinsurance recoveries) decreased in 2004 and 2003 because of lower-than-anticipated losses in homeowners and dwelling fire lines of business. As a result of changes in estimates of insured events in prior years, the provision for claims and claim adjustment expenses (net of reinsurance recoveries) decreased in 2002 because of lower-than-anticipated losses in commercial and private passenger automobile lines of business.

The Company has a geographic exposure to catastrophe losses in certain areas of the country. Catastrophes can be caused by various events including hurricanes, windstorms, earthquakes, hail, severe winter weather, explosions and fires, and the incidence and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Most catastrophe losses are restricted to small geo-

NOTE 9 - POLICY AND CLAIM RESERVES CONTINUED

graphic areas; however, hurricanes and earthquakes may produce significant damage in large, heavily populated areas. The Company generally seeks to reduce its exposure to catastrophes through individual risk selection and the purchase of catastrophe reinsurance.

NOTE 10 – REINSURANCE

The Company's insurance operations participate in reinsurance in order to limit losses, minimize exposure to large risks, provide additional capacity for future growth and effect business-sharing arrangements. Life reinsurance is accomplished through yearly renewable term. Property and casualty reinsurance is placed on both a quota-share and excess of loss basis. Reinsurance ceded arrangements do not discharge the insurance subsidiaries as the primary insurer, except for cases involving a novation. Failure of reinsurers to honor their obligations could result in losses to the insurance subsidiaries. The insurance subsidiaries evaluate the financial conditions of their reinsurers and monitor concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize their exposure to significant losses from reinsurance insolvencies. At December 31, 2004, reinsurance receivables with a carrying value of $326,000 ($765,000 at December 31, 2003) and prepaid reinsurance premiums of $467,000 ($496,000 at December 31, 2003) were associated with a single reinsurer. The amounts of recoveries pertaining to reinsurance contracts that were deducted from losses incurred during 2004, 2003 and 2002 were approximately $11,284,000, $580,000, and $374,000, respectively. The significant increase in recoveries pertaining to reinsurance contracts in 2004 compared to prior years was due to reinsurance associated with losses incurred from hurricane Ivan. The effect of reinsurance on premiums written and earned was as follows:

Dollars in thousands	2004			
	Life		Property & Casualty	
	Written	Earned	Written	Earned
Direct	$ 6,176	$ 6,200	$47,870	$51,618
Assumed	–	–	–	–
Ceded	(27)	(27)	(4,835)	(4,806)
Net	$ 6,149	$ 6,173	$ 43,035	$ 46,812

Dollars in thousands	2003			
	Life		Property & Casualty	
	Written	Earned	Written	Earned
Direct	$ 5,719	$ 5,843	$45,507	$44,666
Assumed	–	–	500	500
Ceded	(44)	(44)	(3,276)	(3,429)
Net	$ 5,675	$ 5,799	$ 42,731	$ 41,737

Dollars in thousands	2002			
	Life		Property & Casualty	
	Written	Earned	Written	Earned
Direct	$ 5,526	$ 5,441	$31,959	$29,350
Assumed	–	–	–	–
Ceded	(45)	(45)	(2,063)	(2,115)
Net	$ 5,481	$ 5,396	$ 29,896	$27,235

NOTE 11 - EMPLOYEE BENEFIT PLAN

In 1989, the Company and its subsidiaries established a retirement savings plan and transferred the assets from the defined contribution profit sharing plan into the new plan. All full-time employees who have completed one year of service at January 1 or July 1 are eligible to participate and all employee contributions are fully vested for employees who have completed 1,000 hours of service in the year of contribution. Contributions for 2004, 2003, and 2002 amounted to $189,000, $228,000, and $177,000, respectively. Contributions are at the Board of Directors' discretion subject to governmental limitations.

In 1987, the Company established a deferred compensation plan for its Board of Directors. The Board members have an option of deferring their fees to a cash account or to a stock account and all share deferrals are recorded at the fair market value on the date of the award. Costs of the deferred compensation plan for 2004, 2003, and 2002 amounted to approximately $208,000, $421,000, and $19,000, respectively. The deferred compensation plan was frozen on December 31, 2004. It is anticipated that a new plan will be adopted during 2005 to allow directors to defer fees under a non-qualified plan. Until such plan is adopted all fees will be paid in cash.

NOTE 12 - REGULATORY REQUIREMENTS AND DIVIDEND RESTRICTIONS

The amount of dividends paid NSIC to the Company may not exceed, without prior approval of regulatory authorities, the greater of 10% of statutory surplus as of the end of the preceding year, or the statutory net gain from operations for the preceding year. At December 31, 2004, NSIC's retained earnings unrestricted for the payment of dividends in 2005 amounted to $1,029,000.

NSFC is similarly restricted in the amount of dividends payable to the Company; dividends may not exceed the greater of 10% of statutory surplus as of the end of the preceding year, or net income for the preceding year. At December 31, 2004, NSFC's retained earnings unrestricted for the payment of dividends in 2005 amounted to $2,376,000.

At December 31, 2004, securities with market values of $3,655,000 ($3,606,000 at December 31, 2003) were deposited with various states pursuant to statutory requirements.

Under applicable Alabama insurance laws and regulations, NSFC is required to maintain a minimum total surplus (to include both paid-in and contributed and unassigned surplus) of $100,000.

Under applicable Alabama insurance laws and regulations, NSIC is required to maintain a minimum total surplus (to include both paid-in and contributed and unassigned surplus) of $200,000.

Under applicable Alabama insurance laws and regulations, Omega is required to maintain a minimum total surplus (to include both paid-in and contributed and unassigned surplus) of $600,000.

NOTE 13 - SHAREHOLDERS' EQUITY

Preferred Stock

The Preferred Stock may be issued in one or more series as shall from time to time be determined and authorized by the Board of Directors. The directors may make specific provisions regarding (a) the voting rights, if any (b) whether such dividends are to be cumulative or noncumulative (c) the redemption provisions, if any (d) participating rights, if any (e) any sinking fund or other retirement provisions (f) dividend rates (g) the number of shares of such series and (h) liquidation preference.

Common Stock

The holders of the Class A Common Stock will have one-twentieth of one vote per share, and the holders of the common stock will have one vote per share.

In the event of any liquidation, dissolution or distribution of the assets of the Company remaining after the payments to the holders of the Preferred Stock of the full preferential amounts to which they may be entitled as provided in the resolution or resolutions creating any series thereof, the remaining assets of the Company shall be divided and distributed among the holders of both classes of common stock, except as may otherwise be provided in any such resolution or resolutions.

NOTE 14 - INDUSTRY SEGMENTS

The Company and its subsidiaries operate primarily in the insurance industry. Premium revenues and operating income by industry segment for the years ended December 31, 2004, 2003 and 2002 are summarized below:

Dollars in thousands	Total	P&C Operations	Life Insurance Operations	Non-Insurance Operations
Year ended December 31, 2004				
Revenues				
Net premiums earned	$ 52,985	$ 46,812	$ 6,173	$ –
Net investment income	4,328	2,315	2,013	–
Net realized investment gains	2,162	1,881	276	5
Net revenues from leasing operations	2,459	–	–	2,459
Other income (loss)	1,312	1,325	9	(22)
	$ 63,246	$ 52,333	$ 8,471	$ 2,442
Income (loss) before income taxes	$ 4,580	$ 4,224	$ 216	$ 140
Interest expense	727	–	30	697
	$ 3,853	$ 4,224	$ 186	$(557)
Assets	$128,631	$ 65,462	$ 45,947	$ 17,222
Amortization of deferred policy acquisition costs	$ 2,221	$ 2,115	$ 106	$ –
Depreciation expense	$ 805	$ 188	$ 173	$ 444
Capital expenditures	$ 1,327	$ 130	$ 663	$ 534

NOTE 14 - INDUSTRY SEGMENTS CONTINUED

Dollars in thousands	Total	P&C Operations	Life Insurance Operations	Non-Insurance Operations
Year ended December 31, 2003				
Revenues				
Net premiums earned	$ 47,536	$ 41,737	$ 5,799	$ –
Net investment income	4,080	2,131	1,865	84
Net realized investment gains	1,416	460	956	–
Net revenues from leasing operations	1,433	–	–	1,433
Other income	1,395	1,383	12	–
	$ 55,860	$ 45,711	$ 8,632	$ 1,517
Income (loss) before income taxes	$ 6,260	$ 5,720	$ 563	$(23)
Interest expense	632	–	34	598
	$ 5,628	$ 5,720	$ 529	$(621)
Assets	$127,236	$ 65,225	$ 45,796	$ 16,215
Amortization of deferred policy acquisition costs	$ 1,825	$ 1,727	$ 98	$ –
Depreciation expense	$ 686	$ 74	$ 312	$ 300
Capital expenditures	$ 8,079	$ 118	$ 645	$ 7,316
Year ended December 31, 2002				
Revenues				
Net premiums earned	$ 32,631	$ 27,236	$ 5,395	$ –
Net investment income	4,235	2,192	1,963	80
Net realized investment gains	1,168	771	397	–
Net revenues from leasing operations	942	–	–	942
Other income	1,051	1,049	2	–
	$ 40,027	$ 31,248	$ 7,757	$ 1,022
Income (loss) before income taxes	$ 1,880	$ 518	$ 1,118	$ 244
Interest expense	410	–	36	374
	$ 1,470	$ 518	$ 1,082	$(130)
Assets	$108,098	$ 54,186	$ 44,719	$ 9,193
Amortization of deferred policy acquisition costs	$ 1,406	$ 1,308	$ 98	$ –
Depreciation expense	$ 289	$ 50	$ 156	$ 83
Capital expenditures	$ 7,658	$ 134	$ 291	$ 7,233

NOTE 15 - CONTINGENCIES

Litigation

The Company and its subsidiaries continue to be named as parties to litigation related to the conduct of their insurance operations. These suits involve alleged breaches of contracts, torts, including bad faith and fraud claims based on alleged wrongful or fraudulent acts of agents of the Company's subsidiaries, and miscellaneous other causes of action. Most of these lawsuits include claims for punitive damages in addition to other specified relief.

In two separate actions, NSIC is named as a defendant in purported class actions relating to the past sale of industrial burial insurance. The actions address whether the premiums charged were "excessive" relative to the benefit provided and whether the premiums charged were in any manner discriminatory relative to the race of the person insured. In addition, several individual actions on behalf of specifically named persons have been filed with similar allegations. No class has been certified in either of the purported class actions although a Motion for Class Certification has been filed in one of the actions. While NSIC did at one time sell industrial burial insurance, no such plans have been sold for several decades.

NSFC was named a defendant in a Washington County, Alabama action alleging fraud and bad faith in connection with a claim for wind damage to a mobile home. This action was settled in January 2004 under terms which required that the amount be kept confidential. The amount of this settlement has been reflected in the financial statements for the period ending December 31, 2003.

The company establishes and maintains reserves on contingent liabilities. In many instances, however, it is not feasible to predict the ultimate outcome with any degree of accuracy. While a resolution of these matters may significantly impact consolidated earnings and the Company's consolidated financial position, it remains management's opinion, based on information presently available, that the ultimate resolution of these matters will not have a material impact on the Company's consolidated financial position. However, it should be noted that instances of class action lawsuits against insurance companies appear to be increasing in several states in which insurance subsidiaries of the company operate.

NOTE 16 - SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during 2004 was $645,000 ($611,000 in 2003 and $361,000 in 2002). Cash paid for income taxes in 2004 was $2,000,000 ($400,000 in 2003 and $110,000 in 2002). In 2003, Mobile Attic acquired $7,134,950 of assets through debt ($4,637,743 in 2002).

NOTE 17 - RELATED PARTY TRANSACTIONS

During the years ended December 31, 2004, 2003 and 2002 the Company's affiliate Mobile Attic acquired $1,389,404, $7,199,700 and $6,497,400, respectively, of equipment from Cash Brothers Leasing, Inc. (Cash Brothers). The principal owners of Cash Brothers are also stockholders in Mobile Attic. Cash Brothers is also a distributor of the mobile storage units. During 2004, 2003 and 2002 Mobile Attic paid $100,526, $82,892 and $43,256, respectively, in commissions to Cash Brothers. At December 31, 2004, Mobile Attic had accrued expenses due Cash Brothers of $22,195.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and
Shareholders of The National Security Group, Inc.

We have audited the accompanying consolidated balance sheets of The National Security Group, Inc. and subsidiaries as of December 31, 2004, 2003 and 2002, and the related consolidated statements of income, shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2004. These consolidated financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The National Security Group, Inc. and subsidiaries as of December 31, 2004 and 2003, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America.

Barfield, Murphy, Shank & Smith, P.C.

Birmingham, Alabama
February 25, 2005

Board
of directors

Winfield Baird
Chairman of the Board
The National Security Group, Inc.
Chartered Financial Analyst
Baird Financial Management
Birmingham, Alabama

William L. Brunson, Jr.
President & Chief Executive Officer
The National Security Group, Inc.
Elba, Alabama

Jack E. Brunson
President
National Security Fire and
Casualty Company
Elba, Alabama

Mickey Murdock, CPA
Chief Operating Officer and
Senior Vice President
The National Security Group, Inc.
Elba, Alabama

J. R. Brunson
Retired President & Chief Executive Officer
The National Security Group, Inc.
Elba, Alabama

Carolyn E. Brunson
Managing Partner
Brunson Properties
Elba, Alabama

Walter P. Wilkerson, CPA
Partner
Brunson, Wilkerson & Bowden CPAs
Enterprise, Alabama

Fred Clark, Jr.
Executive Director
Electric Cities of Alabama
Montgomery, Alabama

Paul C. Wesch
Executive Vice President & General Counsel
The Mitchell Company
Mobile, Alabama

L. Brunson White
Vice President & Chief Information Officer
Energen Corporation
Birmingham, Alabama

Donald S. Pittman
Attorney at Law
Enterprise, Alabama

Fleming Brooks
President
Brooks Peanut Company, Inc.
Samson, Alabama

Frank B. O'Neil
Senior Vice President
Corporate Communications and Investor
Relations and Assistant Corporate Secretary
Pro Assurance
Birmingham, Alabama

James B. Saxon
Director Emeritus
Retired Executive
Anderson Products
Square D Company
Birmingham, Alabama

Corporate
information

For Copy of Annual Report,
Proxy or 10K, or For More Information Contact:

Brian McLeod
Chief Financial Officer
The National Security Group, Inc.
661 East Davis Street
Elba, Alabama 36323
334-897-2273

Annual Shareholders Meeting:

May 12, 2005
Executive Offices
Elba, Alabama

Auditors:

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Birmingham, Alabama 35244

Actuaries:

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Wakely Actuarial
33 North Garden Avenue
Suite 1100
Clearwater, Florida 33755-6606

Fire Company-
Milliman & Robertson, Inc.
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San Francisco, CA 94108

The Common Stock of the Company trades on the NASDAQ Stock Market℠ under the symbol NSEC. Quotations are furnished by the National Association of Security Dealers Automated Quotations System (NASDAQ) and appear in the Wall Street Journal and other financial publications.

Trade Symbol: NSEC

Transfer Agent: The National Security Group, Inc.
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THE NATIONAL SECURITY GROUP, INC.

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